Special Release

IT 02-2

**EXPLANATORY NOTES TO THE JANUARY 29, 2002
IOTICE OF WAYS AND MEANS MOTION (BILL C-49)
TO IMPLEMENT CERTAIN PROVISIONS OF THE
DECEMBER 10, 2001 BUDGET
(Income Tax Act amendments
only reproduced)**

**DRAFT INCOME TAX REGULATIONS
RE CCA CLASS 43.1, AND QUALIFIED
LIMITED PARTNERSHIPS**

February 5, 2002

CARSWELL
A THOMSON COMPANY

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Great care has been taken to ensure that this publication is correct, but there is no warranty of complete accuracy.

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Immediate release

Ottawa, February 5, 2002
2002-013

LEGISLATION INTRODUCED FOR 2001 BUDGET INITIATIVES

Secretary of State (International Financial Institutions) John McCallum, on behalf of Finance Minister Paul Martin, today introduced legislation to implement provisions of the budget tabled in the House of Commons on December 10, 2001.

The legislation includes measures to:

- establish the Canadian Air Transport Security Authority to deliver improved security at Canadian airports and on board flights;
- implement the Air Travellers Security Charge as of April 1, 2002, to fund the air security enhancements;
- implement amendments to the Employment Insurance Act related to maternity and parental benefits in certain situations;
- implement income tax amendments that were announced in the 2001 budget;
- implement the $2-billion Canada Strategic Infrastructure Fund, which will provide assistance to large infrastructure projects in co-operation with municipal and provincial governments, as well as with the private sector; and
- provide for the new $500-million Africa Fund to help reduce poverty, provide primary education and set Africa on a sustainable path to a brighter future.

Minister Martin today released explanatory notes relating to the Air Travellers Security Charge Act and to the amendments to the Income Tax Act included in the bill. Also released were draft Interest Rate Regulations under the new Air Travellers Security Charge Act and draft amendments to the Income Tax Regulations to implement the measures announced in the budget relating to qualified limited partnerships and to renewable energy and energy efficiency.

The attached backgrounder provides a summary of the key components of the bill.

The explanatory notes and draft regulations can be viewed free of charge on the Department of Finance Web site. Printed copies of the document are available for $10 from the Department's Distribution Centre at (613) 995-2855.

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BACKGROUNDER

Canadian Air Transport Security Authority

Budget 2001 allocated $2.2 billion over five years to make air travel more secure in accordance with rigorous new national Transport Canada standards, and announced the creation of a new air security authority. The authority will be responsible for providing:

- armed undercover police officers on Canadian aircraft;
- better-trained personnel to screen passengers and carry-on baggage;
- new state-of-the-art explosives detection systems at Canada's airports; and
- enhanced policing in airports.

The bill provides that the authority will be managed by a board of directors composed of 11 members appointed by the Governor in Council on the recommendation of the Minister of Transport. Two of the directors will be nominees of the airline industry, and two others will be nominees of airport operators.

Air Travellers Security Charge

The Budget 2001 commitment to enhanced air travel security will be funded by a new Air Travellers Security Charge. The charge will apply to air travel occurring after March 31, 2002, for which payment is made after that date, in the case of tickets purchased in Canada, and to air travel occurring after May 31, 2002, for which payment is made after March 31, 2002, in the case of tickets purchased outside Canada.

The total cost of the Air Travellers Security Charge will be the following (amounts include goods and services tax where applicable):

- $12 for one-way travel within Canada;
- $24 for round trip travel within Canada;
- $12 for travel to a destination in the continental U.S. (U.S. taxes also apply); and
- $24 for travel to a destination outside of Canada and the continental U.S.

The charge will apply to flights between the 90 airports planned to benefit from security enhancements under the Canadian Air Transport Security Authority. The 90 airports are listed in the schedule to the new Act. Direct flights to or from small or remote airports that are not on this list of 90 airports will not be subject to the charge.

The Government is committed to an open, transparent process to review the charge annually and to ensure that revenue over the five-year period does not exceed the cost of the enhanced air travel security system.

Employment Insurance

The bill includes amendments to the Employment Insurance Act to provide increased flexibility to parents whose child is hospitalized for an extended period following birth or adoption. A key benefit will be to increase the window during which they can claim parental benefits under the employment insurance program to up to two years.

Income Tax Amendments

The bill includes provisions to implement income tax amendments announced in Budget 2001. These include measures to:

- defer certain corporate income tax instalments for January, February and March 2002 for six months to help small businesses in meeting their cash flow needs;
- exempt from income tax tuition assistance for adult basic education provided under certain government programs, and extend access to the education tax credit;
- permanently implement a 1997 budget measure that provides special tax assistance for donations of publicly listed securities to public charities;
- make it easier for non-residents who invest through partnerships to retain Canadian investment managers and advisors;
- allow apprentice vehicle mechanics to deduct from their income a portion of the cost of new tools, to the extent that those costs exceed the larger of $1,000 or 5 per cent of their apprenticeship income; and
- improve the responsiveness of the goods and services tax credit.

Canada Strategic Infrastructure Fund

In Budget 2001, the Government announced its intention to provide at least $2 billion in funding for large infrastructure projects that can bring lasting economic and social benefits while providing both stimulus and productivity benefits. The Canada Strategic Infrastructure Fund will have the same goals and $2-billion commitment as set out in the budget. The infrastructure areas eligible for the fund include:

- highway or rail infrastructure;
- local transportation infrastructure;
- tourism or urban development infrastructure;
- sewage treatment infrastructure;
- water infrastructure; or
- other infrastructure prescribed by regulation.

The Government will administer the fund. Ministerial accountability to Parliament and Canadian citizens will rest with the Minister of Infrastructure, and the Government will report annually on its commitments and expenditures under the fund.

Africa Fund

In Budget 2001, the Government stated its intention to provide a $500-million fund for African development. We will also go ahead with our program for Africa, in order to preserve our flexibility going into the Kananaskis Summit where we will focus on health, education and other initiatives. The fund will be delivered directly by the federal government.

As agreed at the 2001 Summit in Genoa, the Africa Fund will finance projects and activities set out in the Action Plan for Africa.

Fiscal Framework

As a result of these changes, the Contingency Reserve for 2001-02 will be used for debt paydown. For 2002-03 and 2003-04, the Government plans to use the Contingency Reserve, to the extent that it is not needed to meet unexpected circumstances, to pay down the debt as well.

The public debt interest savings from this debt paydown will provide the fiscal room to finance the disbursements from the Canada Strategic Infrastructure Fund and the Africa Fund over the two years of the Government's budgetary horizon.

Income Tax

Clause 20

Employment Benefits

ITA
Section 6

Section 6 of the *Income Tax Act* provides for the inclusion in an employee's income of most employment-related benefits other than those specifically excluded.

GST Rebates re Costs of Property or Service

ITA
6(8)

Subsection 6(8) of the Act provides rules governing the tax treatment of a GST rebate received by an employee in respect of an amount deducted by the employee under section 8. As a general rule, the GST is included in determining the cost to an employee of any taxable property or service for which a deduction is permitted by section 8 in computing the income of the employee from an office or employment. Where the rebate is in respect of an expense, the rebate is included in computing the income of the employee for the taxation year in which the rebate is received. Where the rebate is in respect of the capital cost of property, the rebate reduces the capital cost of the property at the time the rebate is received.

Subsection 6(8) is amended consequential to the introduction of new paragraph 8(1)(*r*), which provides eligible apprentice mechanics with a deduction in respect of eligible tools. Under amended subsection 6(8), the treatment accorded a GST rebate received in respect of eligible tools is the same as that accorded an expense. That is, the GST rebate is to be included in the taxpayer's income for the taxation year in which it is received.

This amendment applies to the 2002 and subsequent taxation years.

Clause 21

Income from Office or Employment - Deductions

ITA
8

Section 8 of the Act provides for the deduction of various amounts in computing income from an office or employment.

Apprentice Mechanic Deduction for Tools

The 2001 Budget proposed an income tax deduction for the extraordinary cost of new tools acquired by certain apprentice mechanics after 2001. The following explanatory notes discuss in detail the provisions of the Act that are enacted or amended to give effect to this Budget proposal.

In general terms, the legislation describes the types of mechanics that are "eligible apprentice mechanics" as well as the tools acquired in a taxation year that are considered to be "eligible tools". Among other things, an eligible apprentice mechanic's employer must certify in prescribed form that the tools were required as a condition of, and for use in, the apprentice's employment as an eligible apprentice mechanic.

The cost of eligible tools acquired in a taxation year by an eligible apprentice mechanic is deductible in computing income subject to certain limits more fully described below in the note accompanying paragraph 8(1)(*r*) of the Act. Paragraph 8(1)(*r*) also provides a rule under which amounts not previously deducted by an apprentice mechanic are carried forward and may be deducted in a subsequent taxation year.

However, the cost of eligible tools acquired in a taxation year by an eligible apprentice mechanic is to be reduced for income tax purposes in that year. A tool's cost is reduced by the deductible portion of the cost, even if any portion of that cost is not deducted until a subsequent taxation year. As well, proceeds received from the disposition of eligible tools are to be included in income to the extent, in general, that the proceeds exceed the cost (as reduced for income tax purposes) of the disposed of tools. The rules also allow

an apprentice mechanic to transfer on a tax-deferred basis his or her eligible tools to a corporation or partnership.

Apprentice Mechanics' Tool Costs

ITA
8(1)(*r*)

New paragraph 8(1)(*r*) of the Act allows, subject to certain limits, eligible apprentice mechanics to deduct the cost of certain extraordinary expenditures incurred in respect of the cost of eligible tools they are required to acquire and use as a condition of their employment as an apprentice mechanic. Paragraph 8(1)(*r*) applies to eligible tools acquired after 2001. The terms "eligible apprentice mechanic" and "eligible tools" are described in the commentary to new subsection 8(6).

The deduction under new paragraph 8(1)(*r*) in respect of eligible tools of an eligible apprentice mechanic is subject to two income limits. First, the amount claimed by an eligible apprentice mechanic for a taxation year cannot create a non-capital loss – that is, the maximum amount deductible in a year is limited to the amount of the apprentice's income for the year from all sources (which, under section 3 of the Act, cannot be less than nil), computed without reference to the deduction for the cost of eligible tools.

Second, the amount claimed in a year cannot exceed the amount determined by the formula

$$(A - B) + C$$

where

A is the total cost of:

(i) eligible tools acquired in the year, and

(ii) eligible tools acquired in the last 3 months of the preceding taxation year in connection with the employment if the taxpayer first became employed as an eligible apprentice mechanic in the year.

B is the lesser of two amounts. The first amount is the value of A determined for the year (i.e., the value of B cannot exceed the value of A for the year). The second amount is the amount that is the greater of $1,000 and 5% of the apprentice's total employment income from being an apprentice mechanic in the year, computed before deducting an amount for the cost of eligible tools.

C is any carryover amount in respect of the undeducted portion of the amount determined under subparagraph 8(1)(*r*)(ii) in respect of the taxpayer for the preceding taxation year. That is, the amount by which the amount determined under this formula for the preceding year exceeds the amount deducted by the taxpayer under paragraph 8(1)(*r*) for that year. The carryover amount is reduced as the taxpayer claims it.

An example of a deduction under new paragraph 8(1)(*r*) is provided in the explanatory note to new subsections 8(6) and (7). See also the commentary to new paragraph 56(1)(*k*), which provides that any gain from the disposition of eligible tools is to be included in income.

Apprentice Mechanics – Special Rules

ITA
8(6) and (7)

New subsection 8(6) of the Act, which applies to tools acquired after 2001, provides three special rules for the purpose of the apprentice mechanic tools deduction in new paragraph 8(1)(*r*). First, new paragraph 8(6)(*a*) provides that a taxpayer is an eligible apprentice mechanic in a taxation year if, at any time in the year, the taxpayer

- is registered in a program in accordance with the laws of a province that leads to designation under those laws as a mechanic licensed to repair self-propelled motorized vehicles such as automobiles, trucks, aircraft and motorcycles, and

- is employed as an apprentice mechanic.

Second, new paragraph 8(6)(*b*) provides that an eligible tool is a tool (including ancillary equipment – e.g., a tool box) that

- is acquired by a taxpayer for use in connection with the taxpayer's employment as an eligible apprentice mechanic,

- is new (not previously used), and

- is certified in prescribed form by the taxpayer's employer to be required to be provided by the taxpayer as a condition of, and for use in, the taxpayer's employment as an eligible apprentice mechanic.

Third, new paragraph 8(6)(*c*) provides that a former eligible apprentice mechanic is entitled to deduct a carryover amount under paragraph 8(1)(*r*) from a preceding taxation year – i.e., because of the value of the description of C in paragraph 8(1)(*r*).

New subsection 8(7) of the Act provides that where a taxpayer is entitled to deduct an amount for a taxation year under paragraph 8(1)(*r*) in respect of eligible tools, the cost to the taxpayer of the tools is reduced *pro rata* by the deductible amount.

Example:

Assumed facts:

- *The Motor Company hires Abraham on November 1 of Year 1 as an eligible apprentice mechanic (i.e., Abraham enters a provincially recognized program leading to designation as a mechanic licensed to repair self-propelled motorized vehicles and is so employed). Abraham receives $3,000 of income from that employment during the remainder of Year 1 (November and December).*

- *In Year 1, Abraham acquires $4,300 of eligible tools (i.e., the tools are acquired by Abraham in connection with his employment as an eligible apprentice mechanic, the tools are new tools and the Motor Company certifies that the tools were provided by Abraham as a condition of, and for use in, his employment as an eligible apprentice mechanic).*

- *Abraham has other employment income in the year of $17,000.*

1. Maximum deduction in Year 1:

Application of Paragraph 8(1)(r)

Under paragraph 8(1)(r), Abraham may deduct an amount not exceeding the lesser of

(i) $20,000 ($17,000 + $3,000 - section 3 income before deduction), and

(ii) (A – B) + C = ***$3,300***

where

A = $4,300 – i.e., the cost of the new tools

B = $1,000 – being the lesser of

(i) $4,300 (A above), and

(ii) the greater of:

(A) $1,000, and

(B) $ 150 (5% of $3,000)

C = Nil – there is no carryover from the preceding year.

2. *Effect of cost reduction rule in subsection 8(7)*

The reduction under subsection 8(7) of the cost of Abraham's eligible tools for income tax purposes applies on a tool-by-tool basis and is determined in accordance with the following formula:

$$K - (K \times L/M)$$

where

K is the cost of the particular tool determined without reference to any reduction to that cost under subsection 8(7).

L *is the deductible portion of the cost of all eligible tools acquired in the taxation year (i.e., the amount that would be determined under subparagraph 8(1)(r)(ii) if the value of C in that subparagraph were nil).*

M *is the total cost of all eligible tools acquired in the taxation year determined without reference to subsection 8(7) (i.e., the value of A in the formula in subparagraph 8(1)(r)(ii)). See the note to new paragraph 8(1)(r) for additional information.*

Application of Subsection 8(7)

Assume that Abraham acquired one eligible tool that costs $4,300. The cost of that tool is reduced by $3,300 to $1,000 calculated as follows:

K – (K x L/M)

= $1,000, [being $4,300 – ($4,300 x $3,300/$4,300)]

where

K *is $4,300. K is the cost of the eligible tool computed without reference to subsection 8(7).*

L *is $3,300. L would be $3,300 even if Abraham deducted less than that amount in the year, or if Abraham's deduction under paragraph 8(1)(r) were limited by the rule in subparagraph 8(1)(r)(i) that restricts a taxpayer's maximum deduction to his or her income for the year.*

M *is $4,300. M is the cost of all eligible tools computed without reference to subsection 8(7) – i.e., the value of A in the formula in subparagraph 8(1)(r)(ii).*

3. *Description of C in Subparagraph 8(1)(r)(ii) – Carryforward Amounts*

If Abraham were to deduct less than $3,300 in this example because he decides to deduct less than the amount otherwise allowable or because the income limitation rule in subparagraph 8(1)(r)(i) applies, then the non-deducted portion is a carryover amount to which the

description C in paragraph 8(1)(r) applies in the following taxation year. This amount may be carried forward indefinitely.

Clause 22

Gift to Qualified Donee

ITA
38(*a*.1)

Paragraph 38(*a*.1) of the Act provides a temporary special inclusion rate for capital gains arising as a result of a gift of certain securities to qualified donees. This inclusion rate is one half of the normal inclusion rate. This measure was scheduled to expire on December 31, 2001. Paragraph 38(*a*.1) is amended to extend the application of this measure indefinitely.

Clause 23

Adjusted Cost Base Reductions

ITA
53(2)

Subsection 53(2) of the Act provides for reductions in computing the adjusted cost base of a taxpayer's property.

ITA
53(2)(*m*)

Paragraph 53(2)(*m*) requires the adjusted cost base to a taxpayer of a property to be reduced by the amount of that cost that is deductible (otherwise than under the capital gain/loss provisions) in computing the taxpayer's income. Paragraph 53(2)(*m*) is amended effective after 2001 consequential to the enactment of new paragraph 8(1)(*r*) of the Act, which provides a deduction with respect to the cost of eligible tools acquired by an eligible apprentice mechanic. The deduction under paragraph 8(1)(*r*) in respect of eligible tools is excluded from the cost base reduction because subsection 8(7) already provides for a reduction of the cost of the tools for income tax purposes.

Clause 24

Apprentice Tools, re Proceeds

ITA
56(1)(*k*)

New paragraph 56(1)(*k*) of the Act provides a rule that applies to all amounts received by a person (vendor) who is entitled to an apprentice mechanic tool deduction for certain property under new paragraph 8(1)(*r*) of the Act, or who does not deal at arm's with the apprentice mechanic (e.g., a spouse, son or daughter), as consideration for the disposition of such property. In general, the vendor must include in income for a taxation year the amount received in the year only to the extent that the total of the amounts received in the year and preceding years in respect of the disposition exceeds the cost of the property to the vendor (e.g., the reduced cost under new subsection 8(7) of the Act) and the total of amounts previously included in income. However, this rule does not apply to a vendor who acquired the property in a rollover transaction to which new subsection 85(5.1) or subsection 97(5)of the Act applied. (For additional information, see the commentary to those new provisions.)

Example:

Assumed facts:

- *In 2002, Sarah was an eligible apprentice mechanic and the cost of a particular eligible tool owned by her was reduced from $500 to $100 because of subsection 8(7).*

- *In 2003, Sarah disposes of the particular eligible tool for $170, of which $50 is received in 2003 and $120 in 2004.*

Application of Paragraph 56(1)(k)

Year 2003:

Sarah does not have any income under paragraph 56(1)(k) in 2003 because the $50 she received in 2003 does not exceed the $100 cost of the tool.

Year 2004:

Sarah must include $70 in her income for 2004. This $70 is calculated as follows: $120 received in 2004 is included in income to the extent that $170 ($120 + $50) exceeds $100 ($100 + $0 [nil was included in income for a preceding year]).

Clause 25

Repayment of Benefits

ITA
60(*n*)

Paragraph 60(*n*) of the Act provides a deduction for repayments of certain benefits included in income. The amendment to this paragraph is consequential on the introduction of paragraph 110(1)(*g*) of the Act which provides for an offsetting deduction in respect of tuition assistance received under certain programs. (For additional information, see the commentary to new paragraph 110(1)(*g*).) Because tuition assistance eligible for this offsetting deduction is effectively tax-exempt, the amendment to paragraph 60(*n*) ensures that a repayment of any portion of that assistance does not trigger a deduction under that paragraph.

This amendment applies to the 1997 and subsequent taxation years.

Clause 26

Expenses for Food, etc.

ITA
67.1(2)

Subsection 67.1(2) of the Act provides exemptions from the application of the rule in subsection 67.1(1) which deems that amounts paid or payable for meals and entertainment are 50% of the lesser of a reasonable amount and the expenditure actually incurred.

Amended paragraph 67.1(2)(*e*.1), which applies after 2001, provides an exception to the rule in subsection 67.1(1), so that the cost to a taxpayer of meals provided to an employee at a work camp established specifically for the purpose of providing meals and accommodation, to employees working at a construction project, is fully deductible. It is required that the site be far enough from the employee's principal place of residence that the employee could not be expected to return to that residence on a daily basis. Further, the amount must be paid or payable in respect of the employee's duties performed

- at a site in Canada at which the taxpayer carries on a construction activity, or

- at a construction work camp at which the employee is lodged, that was constructed or installed at or near the construction site, to provide board and lodging to employees while they are engaged in construction services at the site.

The exception does not apply to amounts paid or payable in respect of entertainment or a conference, convention, seminar or similar event.

Clause 27

Death of a Taxpayer

ITA
70

Section 70 of the Act provides certain rules that apply on the death of a taxpayer.

Transfer of Farm Property to Child

ITA
70(9)

Subsection 70(9) of the Act provides a rule allowing a tax deferred rollover for capital gains and recaptured depreciation on intergenerational transfers of farm property from a taxpayer to a child

of the taxpayer as a result of the death of the taxpayer. This rule permits the legal representative of the deceased taxpayer to elect to transfer the property at any amount between its cost amount and its fair market value at the time of the death of the taxpayer. The elected amount is deemed to be the cost of the property to the child.

Subsection 70(9) requires that the farm property be used principally in a farming business in which a family member was actively engaged on a regular and continuous basis. While some woodlot owners may be considered to be farmers for income tax purposes, they may not be eligible for this rollover in respect of their woodlots if their woodlot activities are not considered to be regular and continuous. The long-term nature of woodlot operations often means that little or no activity, aside from monitoring, may be required for long periods of time.

Subsection 70(9) is amended to expand the intergenerational rollover provisions available for farm property to land and depreciable property used principally in a woodlot farming business. It will apply where the deceased taxpayer, the taxpayer's spouse or common-law partner or any of the taxpayer's children was engaged in the woodlot operation to the extent required by a prescribed forest management plan in respect of the woodlot.

The expression "prescribed forest management plan" will be defined by regulation. The 2001 Budget announced the Government's intention to develop specific criteria for prescribed forest management plans in consultation with interested parties. In respect of transfers of property before the announcement of these criteria, it is proposed that the regulations will reflect that a prescribed forest management plan is a plan of the deceased taxpayer in respect of the woodlot that provides for the necessary attention to the woodlot's growth, health, quality and composition.

This amendment applies to transfers of property that occur after December 10, 2001.

Example

Mr. X inherited a 200-acre woodlot from his father in 1987. At that time the woodlot contained a mixture of species with varying conditions and ages. In 1993 Mr. X engaged an experienced forest

management consultant to develop a forest management plan that would propose objectives and strategies for development and harvest of the standing timber over an extended period. The plan described the activities that would be required of Mr. X at predetermined future dates in order to provide for the necessary attention to the woodlot's growth, health, quality and composition. The forest management plan was consistent with a business plan developed by Mr. X, in which he prepared a reasonable forecast of the long-term expectations for an operating profit from the woodlot operation. The majority of the expected profit from the operation would be realized between 2000 and 2025.

Mr. X performed the duties contemplated by the forest management plan. Due to his failing health, from 1997 to 2002 the duties were performed either by Mr. X's daughter or by an independent contractor hired by Mr. X.

Mr. X died on January 31, 2002. The woodlot and certain miscellaneous depreciable property that was used principally in the woodlot operation were transferred to his daughter in accordance with the terms of his will. The executor of Mr. X's estate elected under subsection 70(9) of the Act that the proceeds of disposition of the land be its adjusted cost base to Mr. X (which was less than the fair market value), and that the proceeds of disposition of the depreciable property be its fair market value (which was less than the cost amount to Mr. X of that property).

As a result, the executor reported no capital gain or loss on the land on the terminal income tax return of Mr. X, and reported a terminal loss on the depreciable property equal to the excess of its undepreciated capital cost over the elected proceeds of disposition.

ITA
70(9.3)(*b*)

Paragraph 70(9.3)(*b*) of the Act allows a capital gains rollover of a share of a family farm corporation from a spousal trust created by a taxpayer to a child of the taxpayer in consequence of the death of the taxpayer's spouse. The provision applies regardless of whether the taxpayer's spouse, common-law partner, child or parent was actively engaged in the business of the corporation on a regular and continuous basis.

Effective after December 10, 2001, paragraph 70(9.3)(*b*) is amended, consequential to the amendment of the definition "share of the capital stock of a family farm corporation" in subsection 70(10) of the Act, to provide that, in the case of a woodlot operation, those persons need not be engaged in the woodlot operations, for the purposes of this rollover.

Definitions

ITA
70(10)

Subsection 70(10) of the Act provides several definitions that are used in section 70 and certain other provisions of the Act that deal with intergenerational rollovers. The definitions "interest in a family farm partnership" of a person and "share of the capital stock of a family farm corporation" of a person in the subsection are amended concurrently with the amendment of subsections 70(9) and 73(3) of the Act in respect of the intergenerational rollover of property used in a woodlot operation that is a farming business. These definitions provide that substantially all of the fair market value of the property of the partnership or corporation be attributable to land and depreciable property used principally in a farming business in which the person, the person's spouse or common-law partner or any of the person's children was actively engaged on a regular and continuous basis. Such an interest or share is eligible for an intergenerational rollover to a child under subsection 70(9.2) or 73(4) of the Act.

The definitions are amended, effective after December 10, 2001, to provide that the eligible property of such a partnership or corporation may include the fair market value of land or depreciable property used principally in a woodlot farming business of the partnership or corporation in which the person or family member was engaged the extent required by a prescribed forest management plan in respect of the woodlot.

The notes to subsection 70(9) describe a prescribed forest management plan.

Clause 28

***Inter vivos* Transfer of Farm Property to Child**

ITA
73(3)

Subsection 73(3) of the Act provides a tax deferred rollover for capital gains and recaptured depreciation on an *inter-vivos* transfer of farm property by a taxpayer to a child of the taxpayer. This rule permits the taxpayer to elect to transfer the property at any amount between its cost amount and its fair market value at the time of the transfer. The elected amount is deemed to be the cost of the property to the child.

Before the transfer, the farm property must be used principally in a farming business in which the taxpayer or the taxpayer's spouse, common-law partner or a child was actively engaged on a regular and continuous basis. While some woodlot owners may be considered to be farmers for income tax purposes, they may not be eligible for this rollover in respect of their woodlots if their activities are not considered to be regular and continuous. The long-term nature of woodlot operations means that often little or no activity, aside from monitoring, may be required for long periods of time.

Concurrent with a similar amendment to subsection 70(9) of the Act, effective after December 10, 2001 subsection 73(3) will apply to circumstances where the taxpayer, the taxpayer's spouse or common-law partner or any of the taxpayer's children was engaged in the woodlot farming business to the extent required by a prescribed forest management plan in respect of the woodlot.

The notes to subsection 70(9) describe a prescribed forest management plan.

Clause 29

Transfer of Property to Corporation by Shareholder

ITA
85

Section 85 of the Act provides for tax-deferred transfers of certain types of properties by a taxpayer to a taxable Canadian corporation in exchange for shares.

Acquisition of Apprentice Tools re Capital Cost and Deemed Depreciation

ITA
85(5.1)

An apprentice mechanic may transfer tools for which he or she was entitled to a deduction under paragraph 8(1)(*r*) of the Act, on a tax-deferred basis to a corporation. In such a case, new subsection 86(5.1) of the Act, which applies after 2001, provides special rules that apply to the corporation for the purpose of determining the capital cost of the corporation's acquired property for capital cost allowance and adjusted cost base purposes as well as in determining the amount of capital cost allowance deemed to have been deducted by the corporation in respect of the property.

These special rules apply if

- the property was acquired by the corporation in circumstances to which subsection 85(1) applied,
- the cost of the property to the apprentice mechanic was reduced under subsection 8(7) of the Act, and
- the property is depreciable property of the corporation.

In such cases, the capital cost to the corporation of the property is deemed to be the original cost of the property to the apprentice mechanic and the amount by which the cost of the property was reduced because of subsection 8(7) is deemed to have been previously deducted by the corporation as capital cost allowance. The difference

is therefore potentially subject to recapture on a subsequent disposition by the corporation. A capital gain can also arise on a subsequent disposition to the extent that proceeds of disposition in respect of the property exceed the amount deemed to be the tool's adjusted cost base (i.e., capital cost).

Clause 30

Amalgamations – Rules Applicable

ITA
87(2)

Section 87 of the Act provides rules that apply where there has been an amalgamation of two or more taxable Canadian corporations to form a new corporation. The new corporation is generally treated as a continuation of its predecessor corporations for the purposes of the Act.

Subsections 125(5.1) and 157.1(1)

ITA
87(2)(*j*.92)

Paragraph 87(2)(*j*.92) of the Act is amended consequential to the introduction of section 157.1 of the Act, which allows eligible corporations to defer the payment of their eligible instalments of tax by at least six months. This amendment ensures that the definition "eligible corporation" in subsection 157.1(1) will apply to an amalgamated corporation as though it were a continuation of its predecessor corporations. The provisions of paragraph 87(2)(*j*.92) also apply, pursuant to paragraph 88(1)(*e*.2), for the purposes of the rules relating to the winding-up of a subsidiary into its parent corporation.

This amendment applies to taxation years that end after 2001.

Refundable Investment Tax Credit and Balance-due Day

ITA
87(2)(*oo*.1)

Paragraph 87(2)(oo.1) of the Act applies for the purpose of determining a new corporation's eligibility for refundable investment tax credits and for the one-month extension of the corporation's balance-due day under subparagraph 157(1)(*b*)(i). This paragraph is amended consequential to the relocation of the portion of the definition "balance-due day" in respect of a corporation from paragraph 157(1)(*b*) of the Act to paragraph (*d*) of the definition "balance-due day" in subsection 248(1) of the Act.

This amendment applies to taxation years that end after 2001.

Clause 31

Refundable Investment Tax Credit and Balance-due Day

ITA
88(1)(*e*.9)

Paragraph 88(1)(*e*.9) of the Act determines a parent corporation's eligibility for refundable investment tax credits and the one-month extension of the corporation's balance-due day under subparagraph 157(1)(*b*)(i). This paragraph is amended consequential to the relocation of the definition "balance-due day" in respect of a corporation from paragraph 157(1)(*b*) of the Act to paragraph (*d*) of the definition of "balance-due day" in subsection 248(1) of the Act.

This amendment applies to taxation years that end after 2001.

Clause 32

Acquisition of Apprentice Tools re Capital Cost and Deemed Depreciation

ITA
97(5)

An apprentice mechanic may transfer tools for which he or she was entitled to a deduction under paragraph 8(1)(*r*) of the Act, on a tax-deferred basis to a partnership. In such a case, new subsection 97(5) of the Act, which applies after 2001, provides special rules that apply to the partnership for the purpose of determining the capital cost of the partnership's acquired property for capital cost allowance and adjusted cost base purposes as well as in determining the amount of capital cost allowance deemed to have been deducted by the partnership in respect of the property.

These special rules apply if

- the property was acquired by the partnership in circumstances to which subsection 97(2) applied,

- the cost of the property to the apprentice mechanic was reduced under subsection 8(7), and

- the property is depreciable property to the partnership.

In such cases, the capital cost to the partnership of the property is deemed to be the original cost of the property to the apprentice mechanic, and the amount by which that cost was reduced because of subsection 8(7) is deemed to have been previously deducted by the partnership as capital cost allowance. The difference is therefore potentially subject to recapture on a subsequent disposition by the partnership. A capital gain can also arise on a subsequent disposition to the extent that proceeds of disposition in respect of the property exceed the amount deemed to be the tool's adjusted cost base (i.e., capital cost).

Clause 33

Deduction for Payments

ITA
110

Section 110 of the Act provides various deductions that may be claimed in computing a taxpayer's taxable income.

Charitable Donation of Employee Option Securities

ITA
110(1)(*d*.01)

Paragraph 110(1)(*d*.01) of the Act allows an employee a special deduction in respect of a portion of the employment benefit that the employee is deemed by subsection 7(1) of the Act to have received in connection with the acquisition of a security under an employee option agreement, if the employee donates the security to a qualified donee (other than a private foundation). Generally, the amount of deduction available for securities acquired after October 17, 2000 is ¼ of the employment benefit of the employee in respect of the acquisition. In order to qualify for the deduction, the donation must be made in the same year as the security is acquired and no later than 30 days after acquisition.

This provision to allow a special deduction was scheduled to expire on December 31, 2001. Paragraph 110(1)(*d*.01) is amended to extend the application of this measure indefinitely.

ITA
110(1)(*g*)

New paragraph 110(1)(*g*) provides a deduction for tuition assistance received in connection with basic adult education. Generally, the deduction will be available in respect of tuition assistance received under a program established under the authority of the *Department of Human Resources Development Act* or a similar provincial program under a labour-market agreement. Furthermore, this new deduction will be restricted to instances where the amount of the assistance is included in the student's income and the student is not allowed to

claim a tuition fee credit for the tuition fees paid under the program. Finally, this new offsetting deduction is applicable only to tuition assistance and not to other types of assistance a student may receive in connection with the student's training.

New paragraph 110(1)(*g*) applies to the 1997 and subsequent taxation years.

Clause 34

Non-capital Losses

ITA
111(8)

Subsection 111(8) of the Act contains definitions that apply for the purposes of loss carryovers. The definition "non-capital loss", which takes the form of a formula, is amended to include a reference to new paragraph 110(1)(*g*) of the Act. That paragraph allows an offsetting deduction in respect of tuition assistance received under certain programs. (For additional information, see the commentary to new paragraph 110(1)(*g*).) The amendment to the definition "non-capital loss" – which is made by modifying the description of E in the definition – applies to the 1997 and subsequent taxation years.

Clause 35

Non-residents with Canadian Investment Service Providers

ITA
115.2

Section 115.2 of the Act is an interpretive rule that ensures that, provided certain conditions are met, a qualified non-resident is not considered to be carrying on business in Canada solely because of the provision to the non-resident of designated investment services by a Canadian service provider.

Currently, the term "qualified non-resident" excludes partnerships of which one or more members are resident in Canada. This means that

the non-resident members of such a partnership may not be able to rely on the protection offered by section 115.2.

Section 115.2 is amended to apply to all non-resident persons, including those who are members of a partnership of which one or more members are resident in Canada. In effect, the section will not apply to a partnership *per se*, but rather to the partners themselves. In this regard, the definition "qualified non-resident" in subsection 115.2(1) is repealed, and a number of consequential amendments are made that remove references to that definition.

Further amendments to section 115.2, including the addition of new paragraph 115.2(2)(*c*), clarify that non-resident persons may still avail themselves of the benefit of this rule where the designated investment services are not directly provided to them but to a partnership, of which they are members and of which one or more members are resident in Canada. New subparagraphs 115.2(2)(*c*)(i) and (ii) place restrictions – comparable to those found in subparagraph 115.2(2)(*b*)(iii) – upon the application of the rule in those instances.

These changes to section 115.2 apply to the 2002 and subsequent taxation years.

New definition "Canadian investor" in subsection 115.2(1) simplifies the wording of new clauses 115.2(2)(*b*)(i)(A) and (B), which in part serve to add organizational clarity to subparagraph 115.2(2)(*b*)(i). Current subparagraph 115.2(2)(*b*)(i) precludes a non-resident from benefiting from section 115.2 if, before the particular time, an investment in the non-resident was sold to a person who is a resident of Canada. This rule is modified by clause 115.2(2)(*b*)(i)(B), which denies a non-resident the benefit of this section only if at the particular time a person, who at the time of the sale was, and at the particular time is, a Canadian investor, holds an outstanding investment in the non-resident person.

These amendments to section 115.2 apply to the 1999 and subsequent taxation years. Transitional rules for the definition "Canadian investor" and subparagraph 115.2(2)(*b*)(i) ensure that the wording of these provisions is consistent with the rest of section 115.2, given that the repeal of the definition "qualified non-resident" does not apply, as noted above, until the 2002 taxation year.

Clause 36

Education Tax Credit

ITA
118.6(1)

Subsection 118.6(1) of the Act provides for various education-related definitions for the purposes of the child care and attendant care expense deductions and the tuition and education tax credits. The definition "qualifying educational program" in subsection 118.6(1) is amended to ensure that the receipt by an individual of government assistance under programs established under the authority of the *Department Human Resources Development Act* or similar provincial programs under labour-market agreements will not be taken into account in determining whether the educational program in which the individual is enrolled is a qualifying educational program.

This amendment applies to the 2002 and subsequent taxation years.

Clause 37

Deduction from Tax Payable where Employment out of Canada

ITA
122.3(1)(*e*)(iii)

Section 122.3 of the Act provides a tax credit to Canadian residents who are employed outside Canada by a specified employer for at least six months in connection with resource, construction, installation, agricultural or engineering contracts or for the purpose of obtaining those contracts. This credit is commonly known as the overseas employment tax credit (OETC). The computation of the OETC takes into account certain deductions allowed in computing taxable income. Subparagraph 122.3(1)(*e*)(iii) is amended to include a reference to new paragraph 110(1)(*g*) of the Act which allows, in computing taxable income, an offsetting deduction in respect of tuition assistance received under certain programs. (For additional information, see the commentary to new paragraph 110(1)(*g*).)

This amendment applies to the 1997 and subsequent taxation years.

Clause 38

Goods and Services Tax Credit

ITA
122.5

Section 122.5 of the Act provides the rules for determining the goods and services tax credit (GSTC) for individuals.

Currently, the GSTC is computed on the basis of income and family information provided in the previous year's income tax return. As a result, the credit does not respond to changes in family circumstances that occur in the current year. In some circumstances, such as the birth of a child, the GSTC paid to an eligible individual may not reflect these changes for as long as 18 months.

Section 122.5 is amended to provide that the eligibility to the credit and the amount paid in each quarter will reflect changes in family circumstances that occurred before the end of the preceding quarter.

All the amendments to section 122.5 apply starting July 2002, the month of the first GSTC quarterly payment made in relation to the 2001 taxation year.

Definitions

ITA
122.5(1)

Subsection 122.5(1) of the Act contains definitions for the purposes of the GSTC. The definitions "adjusted income", "eligible individual", "qualified dependant" and "qualified relation" are amended to allow for a determination of an individual's eligibility to the GSTC at the beginning of each quarter. Thus, starting with the July 2002 payments, the eligibility for the credit and the amount of the quarterly payment will reflect the family situation at the beginning of each quarter. Under existing rules, this was determined at the end of the previous year. The definition "cohabiting spouse or common law partner" is added to ensure consistent treatment for the purposes of the Canada Child Tax Benefit (CCTB) and the GSTC. Also added to that list is the definition "return of income". While

this latter addition does not affect GSTC claims made by Canadian residents, it allows claims to be made by new residents on the basis of a prescribed form, given that, in all likelihood, no Canadian income tax returns will have been filed by those new residents before their arrival in Canada.

Persons not Eligible

ITA
122.5(2)

Subsection 122.5(2) of the Act stipulates that the GSTC is not available in respect of certain individuals (for example, deceased persons, officers and servants of foreign countries and prisoners). The amendment to that subsection ensures that the GSTC is denied only when those circumstances prevail at the beginning of the quarter for which a GSTC payment is made (and for a 90-day period in the case of prisoners). It also clarifies that, as for the CCTB, no GSTC may be claimed for a person in respect of whom an allowance is payable under the *Childrens' Special Allowances Act*. Finally, it incorporates the restriction concerning non-residents (other than certain spouses or common-law partners of deemed residents) and deceased individuals, which is currently found in paragraph 122.5(5)(*c*).

Deemed Payment

ITA
122.5(3)

Subsection 122.5(3) provides for the calculation of the GSTC strictly on the basis of information contained in the previous year's tax return. This subsection is amended to ensure that the GSTC is computed quarterly, and thus reflects changes in family circumstances that occurred before the end of the preceding quarter.

Minimum Amount

ITA
122.5(3.1) and (3.2)

New subsections 122.5(3.1) and (3.2) of the Act provide that, where a particular quarterly GSTC payment in relation to a taxation year is less than $25 and it is reasonable to conclude that each subsequent quarterly payment in relation to the same year will not exceed $25, the total of each such subsequent payment will be included in the particular payment. This rule replaces a similar one currently found in paragraph 122.5(5)(*b*).

Exception re Eligible Individual

ITA
122.5(5)

Paragraph 122.5(5)(*a*) of the Act provides that, where an individual is a qualified relation of another individual for a period, only one individual may claim the GSTC in respect of the individual for the period. This paragraph is amended to ensure that this restriction does not apply after the breakdown of their marriage or common-law partnership. Paragraph 122.5(5)(*b*) is replaced by new subsection 122.5(3.1). (For additional information see the commentary on that subsection.) The restriction currently found in paragraph 122.5(5)(*c*) has been incorporated in subsection 122.5(2). (For additional information see the commentary on that subsection).

Subsection 122.5(5.1) of the Act, which applies to prisoners, is repealed, as it applied only to amounts deemed to be paid during months specified for the 2000 taxation year. The rules applicable to those individuals are included in revised subsection 122.5(2). (For additional information see the commentary on that subsection.)

Exception re Qualified Dependant

ITA
122.5(6)

Subsection 122.5(6) of the Act stipulates that only one individual may claim a person as a qualified dependant for a particular period. Thus,

for GSTC payments made in relation to the 2001 and subsequent taxation years, two or more individuals who would otherwise be eligible to claim the person as a qualified dependant must agree as to which of them will be the only individual to claim the person as a qualified dependant for the period. If they fail to agree, the person will be the qualified dependant of the individual to whom the CCTB in respect of the person is paid. If no CCTB is paid in respect of the person, the Minister of National Revenue will, based on the circumstances, decide which individual may include the person as a qualified dependant for GSTC purposes.

Notification to Minister

ITA
122.5 (6.1)

New subsection 122.5(6.1) of the Act requires that, where before the last month specified for a taxation year a person ceases to be an eligible individual or the qualified relation or a qualified dependant of an eligible individual, the eligible individual notify the Minister of National Revenue of that fact before the end of the month following the month in which the event occurred.

Non-residents and Part-year Residents

ITA
122.5(6.2)

New subsection 122.5(6.2) of the Act clarifies that, where a person is not resident in Canada throughout a taxation year, that person's income for the year for the purposes of the GSTC calculations is, for greater certainty, equal to the amount that would have been the person's income for the year had the person been resident in Canada throughout the year.

Clause 39

Foreign Tax Credit

ITA
126

Section 126 of the Act provides rules under which taxpayers may deduct, from tax otherwise payable, amounts they have paid in respect of foreign tax. This tax deduction takes into account certain amounts deducted in computing a taxpayer's taxable income.

ITA
126(1),(2.1) and (3)

Subclauses 126(1)(*b*)(ii)(A)(III) and 126(2.1)(*a*)(ii)(A)(III) and subparagraph 126(3)(*b*)(iii) are amended to include a reference to new paragraph 110(1)(*g*) of the Act which allows, in computing taxable income, an offsetting deduction in respect of tuition assistance received under certain programs. (For additional information, see the commentary on new paragraph 110(1)(*g*).)

These amendments apply to the 1997 and subsequent taxation years.

Clause 40

Minimum Tax

ITA
127.52(1)(*h*)

Subsection 127.52(1) of the Act defines an individual's adjusted taxable income for the purpose of determining the individual's minimum tax liability under Part I of the Act. Paragraph 127.52(1)(*h*) provides that only certain deductions available in computing taxable income may be taken into account in that determination. Paragraph 127.52(1)(*h*) is amended to include the amount deducted under new paragraph 110(1)(*g*) of the Act which allows an offsetting deduction in respect of tuition assistance provided under certain programs. (For additional information, see the commentary on new paragraph 110(1)(*g*)).

This amendment applies to the 1997 and subsequent taxation years.

Clause 41

Payment by Corporations

ITA
157(1)

Subsection 157(1) of the Act sets out the required payment dates for corporate income tax instalments and for any balance of corporate taxes payable. Paragraph 157(1)(*b*) determines when a corporation's balance of tax payable for a taxation year is due. This paragraph is amended to refer to a corporation's "balance-due day" consequential to the relocation of that definition in respect of corporations to paragraph (*d*) of the definition "balance-due day" in subsection 248(1) of the Act.

This amendment applies to taxation years that end after 2001.

Clause 42

Instalment Deferrals – Corporations

ITA
157.1

New section 157.1 of the Act enables eligible corporations to defer payment of their corporate tax instalments otherwise becoming due in the months of January, February and March 2002 for a period of at least six months, without payment of interest or penalties.

This new section applies to taxation years that end after 2001.

Definitions

ITA
157.1(1)

"eligible corporation"

An "eligible corporation" for a taxation year means a corporation that is resident in Canada and, if it is not associated with other corporations for the purposes of the Act, did not have more than $15 million of taxable capital employed in Canada in the previous taxation year. If a resident corporation is associated with other corporations, its taxable capital employed in Canada in the previous taxation year must not exceed the amount by which $15 million exceeds the taxable capital employed in Canada of all of the associated corporations in the previous year.

"eligible instalment day"

An "eligible instalment day" means a day in January, February, or March, 2002 on which an instalment on account of the corporation's tax otherwise becomes payable.

Deferred Balance-due Day

ITA
157.1(2)

New subsection 157.1(2) of the Act determines the deferred balance-due day for a taxation year of an eligible corporation to be the later of

- the day that would otherwise be the corporation's balance-due day for the year, and

- the day that is six months after the last eligible instalment day in the taxation year.

Deferred Instalment Day

ITA
157.1(3)

New subsection 157.1(3) of the Act determines the deferred instalment day of eligible instalments of an eligible corporation. Instead of being on the normal instalment day, an eligible instalment becomes payable

- six months after the eligible instalment day if that deferred day is in the same taxation year as the eligible instalment day, and

- in any other case, on the deferred balance-due day as determined by subsection 157.1(2).

Clause 43

Joint Liability – GSTC Payments

ITA
160.1(1.1)

Subsection 160.1(1.1) of the Act provides that, where a person is a qualified relation (that is, a cohabiting spouse or common-law partner) of an individual who is a goods and services tax credit (GSTC) recipient, both the person and the individual are jointly and severally liable for any excess GSTC paid or credited to the individual. This subsection is amended consequential on the amendments to section 122.5 (for additional information see comments on that section) that ensure that the amount of the GSTC reflects changes in family circumstances that occurred in the preceding quarter.

This amendment applies to amounts deemed to be paid during months specified for the 2001 and subsequent taxation years.

Clause 44

Definitions

ITA
248(1)

"balance-due day"

Paragraph (*d*) of the definition of "balance-due day" in subsection 248(1) of the Act is amended to incorporate the substantive provisions of paragraph 157(1)(*b*) rather than referring to it by cross-reference.

This amendment applies to taxation years that end after 2001.

APPENDIX B

DRAFT *INCOME TAX REGULATIONS* AND EXPLANATORY NOTE

Capital Cost Allowance

1. Subsection 1104(13) of the *Income Tax Regulations* is amended by adding the following in alphabetical order:

"blast furnace gas"

"blast furnace gas" means the gas produced in a blast furnace of a steel mill by the chemical reaction of carbon (in the form of coke, coal or natural gas), oxygen and iron ore.

(2) The definition "fossil fuel" in subsection 1104(13) of the Regulations is replaced by the following:

"fossil fuel"

"fossil fuel" means a fuel that is petroleum, natural gas or related hydrocarbons, blast furnace gas, coal, coal gas, coke, lignite or peat.

2.(1) Clause (*d*)(ii)(A) of Class 43.1 in Schedule II to the Regulations is replaced by the following:

(A) has, if acquired after February 21, 1994 and before December 11, 2001, an annual average generating capacity not exceeding 15 megawatts upon completion of the site development, or, if acquired after December 10, 2001, a rated capacity at the installation site not exceeding 50 megawatts, and

(2) Subparagraph (*d*)(iii) of Class 43.1 in Schedule II to the Regulations is replaced by the following:

(iii) an addition or alteration, which is acquired after February 21, 1994 and before December 11, 2001, to a hydro-electric installation described in subparagraph (ii) that results in an increase in generating capacity, if the resulting annual average generating

capacity of the hydro-electric installation does not exceed 15 megawatts,

(iii.1) an addition or alteration, which is acquired after December 10, 2001, to a hydro-electric installation described in subparagraph (ii) that results in an increase in generating capacity, if the resulting rated capacity at the hydro-electric installation site does not exceed 50 megawatts, and

3. (1) Section 1 applies in respect of property acquired after 2000.

(2) Section 2 applies after December 10, 2001.

CAPITAL COST ALLOWANCE

EXPLANATORY NOTES

ITR
1104(13)

Subsection 1104(13) of the *Income Tax Regulations* defines a number of terms used in that subsection and paragraphs (*c*) to (*g*) of capital cost allowance (CCA) Class 43.1 in Schedule II to the Regulations.

Subsection 1104(13) is amended in two respects. First, it is amended to add the definition "blast furnace gas", which is defined to be the gas produced in a blast furnace of a steel mill by the chemical reaction of carbon (in the form of coke, coal or natural gas), oxygen and iron ore. Second, the definition "fossil fuel" is amended to include "blast furnace gas". These changes apply for the purpose of determining whether certain property is included in Class 43.1 because it is part of a system that generates electrical energy with a heat rate attributable to "fossil fuel" of not more than 6,000 BTU per kilowatt-hour of electrical energy generated by the system.

These amendments apply in respect of property acquired after 2000.

ITR
Class 43.1, Schedule II

CCA Class 43.1 applies to certain types of renewable energy and energy conservation equipment. The CCA rate is 30% per year calculated on a declining balance basis.

Changes are made in respect of the types of hydro-electric projects that qualify for Class 43.1 treatment. In particular, the upper limit on the size of small hydro-electric projects that qualify for Class 43.1 is increased to a <u>rated</u> capacity at the installation site of 50 megawatts, from the current limit of an annual <u>average</u> generating capacity of 15 megawatts. Consequently, the new generating capacity test is based on "plated capacity" at the installation site rather than average capacity.

These amendments apply after December 10, 2001.

APPENDIX C

DRAFT *INCOME TAX REGULATIONS* AND EXPLANATORY NOTES

Qualified Limited Partnerships

1. (1) Paragraph 5000(1.1)(*c*) of the *Income Tax Regulations* is repealed.

(2) Section 5000 of the Regulations is amended by adding the following after subsection (1.2):

(1.3) For the purpose of paragraph (*i*) of the definition "foreign property" in subsection 206(1) of the Act, the specified portion of a limited unit in a qualified limited partnership that is held at any time by a specified partner of the partnership is, at that time, not foreign property of the specified partner.

(1.4) For the purpose of subsection (1.3), the specified portion of a limited unit in a qualified limited partnership held at any time by a specified partner is

(*a*) if the number of limited units in the partnership each of which is held at that time by the specified partner or by any other specified partner with whom the specified partner does not deal at arm's length is less than or equal to 30% of the number of limited units in the partnership held at that time by specified partners, the limited unit; and

(*b*) in any other case, that proportion of the limited unit that the cost amount to the partnership of all property (other than foreign property) held by the partnership at that time is of the cost amount to the partnership of all property held by the partnership at that time.

(1.5) For the purposes of subsections (1.3) and (1.4), a specified partner of a qualified limited partnership at any time means a person or partnership that holds at that time a limited unit in the partnership and that is at that time neither

(*a*) the general partner of the partnership; nor

(*b*) a qualified trust or qualified corporation (as those expressions are defined in subsection 259(5) of the Act) to which subsection 259(1) of the Act applies.

(1.6) For the purposes of subsections (1.4) and (1.5), if a person or partnership (other than a taxpayer described in section 205 of the Act) holds at any time a unit or share in a "qualified trust" or "qualified corporation" (as those expressions are defined in subsection 259(5) of the Act), the person or partnership is deemed to hold at that time any property of the trust or corporation that it would be deemed, by paragraph 259(1)(*b*) of the Act, to hold at that time if that person or partnership were a taxpayer described in section 205 of the Act.

(3) Paragraphs (*d*) and (*e*) of the definition "qualified limited partnership" in subsection 5000(7) of the Regulations are replaced by the following:

(*d*) the interests of the limited partners were described by reference to units (in this section referred to as "limited units") of the partnership that were identical in all respects to each other,

2. Section 1 applies after 2001.

QUALIFIED LIMITED PARTNERSHIPS

EXPLANATORY NOTES

ITR
5000

Part XI of the *Income Tax Act* imposes a penalty tax on excess foreign property held by certain trusts and other tax-exempt persons governed by deferred income plans. "Foreign property" is defined in subsection 206(1) of the Act to include an interest in a partnership, except as prescribed by regulation. Paragraph 5000(1.1)(*c*) of the *Income Tax Regulations* prescribes the interest of a limited partner in a qualified limited partnership (QLP) as such an exception.

Subsection 5000(7) of the Regulations defines "qualified limited partnership" as a limited partnership that, at all times since its formation, has satisfied certain conditions. One of the conditions (set out in paragraph (*e*) of the definition) is that no limited partner (or group of non-arm's length limited partners) can hold more than 30% of the units of the partnership.

The QLP regulations are changed in several ways, effective after 2001. In general terms, the 30% ownership limitation is removed, thus allowing a limited partnership to be a QLP even if a limited partner holds more than 30% of the units of the partnership. Generally, units of a QLP held by a deferred income plan continue to be excluded from treatment as foreign property. However, if a plan holds (alone or as part of a non-arm's length group) more than 30% of the units of a QLP, the units held by the plan will be treated as foreign property of the plan in the same proportion as the foreign property held by the QLP.

These changes are accomplished in the following ways.

- The 30% ownership limitation on a QLP is eliminated through the repeal of paragraph (*e*) of the definition "qualified limited partnership" in subsection 5000(7). It should be noted that this allows a partnership that did not qualify as a QLP before 2002, solely because it failed to comply with the 30% ownership limitation, to so qualify after 2001.

- Paragraph 5000(1.1)(*c*), which prescribes an interest of a limited partner in a QLP not to be foreign property, is repealed. New provisions dealing with QLPs are set out in new subsections 5000(1.3) to (1.6) of the Regulations.

- Paragraph (*d*) of the definition "qualified limited partnership", which requires that the interests of the limited partners in a QLP be described by reference to identical units, is amended to indicate that those units are to be referred to in section 5000 as "limited units" of the QLP. This is to allow ease in referring to those units in new subsections 5000(1.3) to (1.5) of the Regulations.

New subsection 5000(1.3) of the Regulations contains the substantive rule for determining the extent to which an interest in a QLP is non-foreign property. Specifically, it provides that the specified portion (as defined in subsection 5000(1.4)) of a limited unit of a QLP that is held at any time by a specified partner (as defined in subsection 5000(1.5)) of the QLP is prescribed not to be foreign property of the specified partner at that time.

New subsection 5000(1.4) of the Regulations defines the specified portion of a limited unit of a QLP held at any time by a specified partner of the QLP. Specifically, paragraph 5000(1.4)(*a*) defines the specified portion to be the whole of the limited unit, if the total number of limited units held at that time, by the specified partner and by other specified partners not dealing at arm's length with the specified partner, does not exceed 30% of the total number of limited units held at that time by all specified partners of the QLP. If the 30% ownership threshold is exceeded, paragraph 5000(1.4)(*b*) defines the specified portion to be that proportion of the limited unit that the total cost amount to the QLP at that time of all its non-foreign property is of the total cost amount to the QLP at that time of all its property. (See Example 1.)

Where only a portion of a limited unit of a QLP held by a specified partner is prescribed not to be foreign property, the remainder of the limited unit is foreign property. In this case, the cost amount of the limited unit to the partner is allocated between the part that is foreign property, and the part that is not, in the same proportion as the limited unit itself is treated as foreign and non-foreign property. (See Example 1.)

Since paragraph 5000(1.4)(*b*) looks to the cost amount of a QLP's property at any time that a limited unit of the QLP is held by the specified partner, the specified portion of the limited unit that is prescribed not to be foreign property will change as the ratio of the cost amount of the QLP's foreign property to the cost amount of its non-foreign property changes. (See Example 2.) Although the determination of the specified portion is ongoing, the only determination that is relevant for purposes of the foreign property penalty tax is the one that is done as at the end of each month since it is at that time that the excess foreign property is determined.

If a QLP holds no foreign property, the specified portion of a limited unit of the QLP held by a specified partner is the whole of the unit, even if the 30% ownership threshold is exceeded.

New subsection 5000(1.5) of the Regulations defines “specified partner” of a QLP for the purposes of new subsections 5000(1.3) and (1.4). Generally, any person or partnership that holds a limited unit of a QLP is a specified partner of the QLP. If a qualified trust or qualified corporation to which the look-through rule in subsection 259(1) of the Act applies holds a limited unit of a QLP, any entity described in section 205 of the Act that has an interest in the trust or corporation is deemed to hold a proportionate share of the QLP unit. Consequently, such an entity is considered to be a specified partner of the QLP. (In general terms, the entities described in section 205 of the Act are trusts and other tax-exempt persons governed by deferred income plans.)

There are two situations in which an investor holding a limited unit of a QLP is not a specified partner of a QLP. The first is where the investor is the general partner of the QLP. The second is where the investor is a qualified trust or qualified corporation to which the look-through rule in subsection 259(1) of the Act applies.

The exclusion of a general partner from the definition “specified partner” is relevant in two ways.

- First, it means that any interest of the general partner in a QLP (including an interest in limited units of the QLP) is treated entirely as foreign property of the partner. This is because subsection 5000(1.3), which prescribes a certain portion of a

limited unit of a QLP not to be foreign property, applies only to limited units held by specified partners. (See Example 3.)

- Second, it means that any limited units of a QLP held by the general partner are disregarded for purposes of the new 30% ownership threshold in subsection 5000(1.4). Thus, even though the general partner of a QLP may be dealing at non-arm's length with a specified partner, the units held by the general partner are ignored in determining the total number of limited units held by the specified partner as part of a non-arm's length group. Also, any limited units held by the general partner of a QLP are ignored in determining the total number of limited units of the QLP held by all specified partners of the QLP. (See Example 3.)

The exclusion of a qualified trust or qualified corporation to which the look-through rule in subsection 259(1) of the Act applies reflects the fact that an entity, described in section 205 of the Act, which has an interest in the trust or corporation is a specified partner of the QLP in its own right. The exclusion of the trust or corporation thus ensures that there is no double counting of its limited units in determining if the 30% ownership threshold in new subsection 5000(1.4) has been exceeded. (See Example 4.)

New subsection 5000(1.6) of the Regulations provides a special rule relating to qualified trusts and qualified corporations, to which subsection 259(1) of the Act apply, where an entity that is not described in section 205 of the Act has an interest in the trust or corporation. The new rule provides that, for the purposes of new subsections 5000(1.4) and (1.5) of the Regulations, the entity is deemed to hold a proportionate share of any property that the entity would be deemed to hold if the entity were described in section 205 of the Act. Thus, if the trust or corporation holds a limited unit of a QLP, the non-section 205 entity is deemed to hold a proportionate share of the unit.

Although the consequence of this rule is to treat the non-section 205 entity as a specified partner of the QLP, its effect is limited to determining the specified portion of limited units of the QLP that are held (either directly or because of the deeming rule in subsection 259(1) of the Act) by entities to which the foreign property rule in Part XI of the Act applies. In particular, the units that the non-section 205 entity is deemed to hold will be taken into account in

determining the total number of limited units held by all specified partners of the QLP. Also, if the entity does not deal at arm's length with an entity to which Part XI of the Act applies, the limited units that the non-section 205 entity is deemed to hold will be relevant in determining whether the 30% ownership threshold has been exceeded in respect of any limited unit of the QLP held by the entity to which Part XI of the Act applies. (See Example 5.)

The following examples illustrate the application of the rules in new subsections 5000(1.3) to (1.6).

Example 1:

The facts:

A QLP has three limited partners (A, B and C). Each of the partners is an entity described in section 205 of the Act. The partners are specified partners, and deal with each other at arm's length. Partners A and B each hold 50 limited units of the QLP. Partner C holds 100 limited units. The general partner holds no limited units. The cost amount to the limited partners of each of their units is $100. The cost amount to the QLP of its non-foreign property is 80% of the cost amount of all its property.

The results:

Since Partners A and B each hold only 25% of the total number of limited units held by all specified partners (i.e., 50/200), the 30% ownership threshold is not exceeded. Thus, each of their units is treated, in its entirety, as non-foreign property.

Since Partner C holds 50% of the total number of limited units held by specified partners (i.e., 100/200), the 30% ownership threshold is exceeded. Since 80% of the QLP's property is non-foreign property, a corresponding portion of each of the limited units held by Partner C is treated as non-foreign property. The remaining portion continues to be foreign property. Therefore, the $100 cost amount of each of Partner C's units is similarly allocated: $80 to the non-foreign property portion and $20 to the foreign property portion.

Example 2:

The facts:

The facts are the same as in Example 1. However, after a period of time, the QLP sells some of its non-foreign property and acquires additional foreign property. As a result, the cost amount to the QLP of its foreign property increases to 30% of the cost amount of all of its property.

The results:

The change in the ratio of foreign property held by the QLP affects only Partner C, since Partner C is the only specified partner exceeding the 30% ownership threshold. The result is that the portion of each limited unit held by Partner C that is prescribed not to be foreign property is reduced to 70%, and the portion that is foreign property increases to 30%. Accordingly, the cost amount of the non-foreign property portion of each unit decreases to $70, while the cost amount of the foreign property portion increases to $30.

Example 3:

The facts:

The facts are the same as in Example 1, except that Partner C is also the general partner.

The results:

Although Partner C holds limited units, Partner C is not a specified partner.

This has consequences for Partners A and B, since the limited units held by Partner C are disregarded in determining if the 30% ownership threshold is exceeded in respect of either Partner A or B. The result is that Partners A and B each hold half of the limited units held by specified partners (i.e., 50/100), and the threshold is exceeded for both. Accordingly, only 80% of each of the units held by Partners A and B are treated as non-foreign property.

The consequences for Partner C are that the limited units held by it are treated, in their entirety, as foreign property.

Example 4:

The facts:

The facts are the same as in Example 1, except that Partner C is a qualified trust to which subsection 259(1) of the Act applies and, thus, is not a specified partner. Three trusts (X, Y and Z) governed by three separate registered pension plans have invested in the qualified trust. Trusts X and Y each hold 15% of the units of the qualifying trust. Trust Z holds the remaining 70% of the units. The pension plan trusts deal at arm's length with each other and with QLP Partners A and B.

The results:

Since there is an election under subsection 259(1), each pension plan trust is deemed to hold a proportionate interest in each of the properties held by the qualifying trust. Thus, Trusts X and Y are deemed to each hold 15% of each of the 100 limited QLP units held by the qualifying trust (as Partner C), and Trust Z is deemed to hold 70% of each of the 100 units.

The fact that the plan trusts are deemed to hold limited units of the QLP means that they are each specified partners of the QLP. This, coupled with the fact that Partner C is not a specified partner, means that the total number of limited units of the QLP held by specified partners is 200.

The limited QLP units that Trusts X and Y are each deemed to hold represent 7.5% of this total number of limited units (i.e., 15/200). Since the 30% ownership threshold is not exceeded for either trust, their units are treated, in their entirety, as non-foreign property.

The limited QLP units that Trust Z is deemed to hold represent 35% of the total number of limited units held by specified partners (i.e., 70/200). Since the 30% ownership threshold is exceeded, the units will be treated as foreign and non-foreign

property of Trust Z in the same proportion as the cost amount to the QLP of its foreign and non-foreign property.

Since the cost amount to the qualifying trust of each limited QLP unit is $100, the cost amount of the proportionate share of each unit that Trust Z is deemed to hold is $70. Accordingly, the cost amount to Trust Z of the non-foreign property portion of each portion of each QLP unit that it is deemed to hold is $56 (i.e., 80% of $70), while the cost amount of the foreign property portion is $14 (i.e., 20% of $70).

Example 5:

The facts:

The facts are the same as in example 4, except that Trust Z is not an entity described in section 205 of the Act and is not dealing at arm's length with Partner A.

The results:

Trust Z is deemed, by new subsection 5000(1.6) of the Regulations, to hold 70% of each of the 100 limited units of the QLP held by the qualified trust. Consequently, Trust Z is considered to be a specified partner of the QLP.

Since Trust Z is not subject to the foreign property rules in Part XI, it is not affected by the deeming rule in subsection 5000(1.6). However, the deeming rule is relevant in determining the foreign property portion of the limited units of the QLP held by the specified partners that are subject to Part XI of the Act (i.e., Partners A and B and Trusts X and Y).

As a result of the deeming rule, the total number of limited units of the QLP held by specified partners remains at 200. Since Partner B continues to hold only 25% of the units, and Trusts X and Y each continue to hold only 7.5% of the units, their units are treated, in their entirety, as non-foreign property.

Since Partner A does not deal at arm's length with Trust Z, the units that Trust Z is deemed to hold must be taken into account in determining the foreign property portion of each limited unit

held by Partner A. Since together they hold 60% of the total number of limited units held by specified partners (i.e., (70+50)/200), the 30% ownership threshold is exceeded in respect of Partner A. Thus, 20% of each of the units held by Partner A is foreign property.